DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0275
INDIANA CORPORATE INCOME TAX
For the Tax Years 1995 through 1999

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ISSUES

I. Sales of Steel Manufacturing Equipment – Gross Income Tax.

Authority: U.S. Const. art. I, § 8; IC 6-2.1-2-2; IC 6-2.1-3-3; Indiana Dept. of Revenue v. Brown Boveri Corp., 439 N.E.2d 561 (Ind. 1982); Mueller Brass Co. v. Gross Income Tax Division, Indiana Dept. of Revenue, 265 N.E.2d 704 (Ind. 1971); Indiana Dept. of Revenue v. Surface Combustion Corp., 111 N.E.2d 50 (Ind. 1953); Gross Income Tax Division, State of Indiana v. Fort Pitt Bridge Works, 86 N.E.2d 685 (Ind. 1949); 45 IAC 1-1-120; 45 IAC 1-1-120(1)(c); 45 IAC 1-1-121(b); 45 IAC 1-1-121(d); 45 IAC 1.1-3-3(a); 45 IAC 1.1-3-3(c)(6); 45 IAC 1.1-3-3(d).

Taxpayer maintains that income derived from the construction, installation, and sale of equipment to Indiana steel manufacturers is not subject to the state's Gross Income Tax because the transactions came within the definition of "interstate commerce."

II. Abatement of the Ten-Percent Negligence and Underpayment Penalties.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks the Department exercise its discretion to abate both the "underpayment" and ten-percent negligence penalties on the ground that the taxpayer exercised reasonable care in attempting to comply with the state's corporate income tax laws.

STATEMENT OF FACTS

Taxpayer is an out-of-state company which designs, assembles, and then sells manufacturing equipment. Some of this equipment is designed for and then sold to Indiana steel companies. Taxpayer does not manufacture the various component parts of this equipment. Instead, it subcontracts with in-state, out-of-state, and foreign vendors to acquire the necessary components. According to taxpayer, it closely supervises the construction of the component parts at the vendors' locations and then accepts delivery of those parts at those same locations. After taxpayer accepts delivery, it arranges for shipment to the customer's manufacturing site by way of common carrier. Once the component parts have arrived at the customer's Indiana location, taxpayer arranges for subcontractors to assemble the component parts. However, taxpayer closely supervises the subcontractors' work because taxpayer is ultimately responsible to the customer for "installation and commissioning of the equipment."

The Department of Revenue (Department) conducted an audit of taxpayer's financial records covering the years 1995 through 1999. The audit concluded that taxpayer should have been paying income tax on the money it received from the Indiana customers with whom it had done business. Taxpayer disagreed with that conclusion arguing that – as an out-of-state entity – the transactions were exempt from Gross Income Tax under the Interstate Commerce Clause. Taxpayer submitted a protest, an administrative hearing was conducted, and this Letter of Findings followed.

DISCUSSION

I. Sales of Steel Manufacturing Equipment – Gross Income Tax.

Indiana Gross Income Tax (IC 6-2.1-0.6 to 6-2.1-8-7) "is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana; and (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident of Indiana." IC 6-2.1-2-2 To assure that only income properly subject to a state tax is assessed Gross Income Tax, IC 6-2.1-3-3 provides that "[g]ross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign county is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution." IC 6-2.1-3-3 was passed in recognition of the fact that the Commerce Clause requires that Indiana not unduly burden commerce between the states. Therefore, Indiana may not impose a tax that discriminates against interstate commerce in favor of intrastate commerce. "While a state may impose a tax burden that is reasonable in light of the incidence of commercial contact by the taxpayer with [the state], a tax system which may produce a multiple taxation burden is proscribed." Mueller Brass Co. v. Gross Income Tax Division, Indiana Dept. of Revenue, 265 N.E.2d 704, 717 (Ind. 1971).

Taxpayer argues that the Indiana sales in question fell within the protection afforded by the Interstate Commerce Clause which reserves to the federal government the power to "regulate Commerce . . . among the several states . . . ." U.S. Const. art. I, § 8. More specifically, taxpayer – for the first of the four years here at issue – cites to 45 IAC 1-1-120(1)(c) which exempts from the Gross Income Tax certain sales made by non-residents to Indiana customers in which the out-of-state sellers perform installation services intrinsically related to the original sale. In regard to "Nontaxable in-shipments," the regulation states that, "As a general rule, income derived from sales made by nonresident sellers to Indiana buyers is not subject to gross income tax unless the seller was engaged in business activity within the state and such activity was connected with or facilitated the sales." 45 IAC 1-1-120. Specifically, the regulation exempts those sales "made by a nonresident where the product sold is, because of its size or weight, shipped in parts; and the seller, because of his special skill or expertise, assembles or installs the product at the buyer's place of business with no additional services rendered." 45 IAC 1-1-120(1)(c). Taxpayer maintains that Indiana may not tax the money it received during 1995 through 1998 because that Indiana source income is protected by the Interstate Commerce Clause and falls within the definition of 45 IAC 1-1-120.

The Department promulgated new regulations governing the Gross Income Tax. Those new regulations became effective January 1, 1999, and govern taxpayer's 1999 Indiana income. Taxpayer maintains that the state may not tax its 1999 Indiana income because that money falls within the definition of "Gross income derived from business conducted in interstate commerce . . . ." 45 IAC 1.1-3-3(a). Taxpayer cites to 45 IAC 1.1-3-3(c)(6) in support of its position. That portion of the regulation requires, in part, as follows:

> Gross income derived from the sale of tangible personal property in interstate commerce is not subject to the gross income tax if the sale is not completed in Indiana. The following examples are situations where a sale is not completed in Indiana prior to or after shipment in interstate commerce . . . (6) A sale, not otherwise taxable, to an Indiana buyer by a nonresident where the seller, because of its special skill or expertise, assembles or installs the product at the buyer's place of business without any additional services being rendered. In other words, the services performed are part of the sale and the sale is exempt because it is in interstate commerce.

Taxpayer cites to Indiana Dept. of Revenue v. Surface Combustion Corp., 111 N.E.2d 50 (Ind. 1953) for support of its contention that the sale of the steel-making equipment to its Indiana customers took place within interstate commerce and the proceeds are exempt from the Gross Income Tax. In Surface Combustion, appellee taxpayer was an Ohio based furnace manufacturer. It sold furnaces to an Indiana customer, was assessed Gross Income Tax on the income derived from the sales, and brought an action seeking a refund of those taxes. The court determined that appellee taxpayer had constructed the furnaces at its Ohio facility. Thereafter, appellee taxpayer transported the smaller furnaces to the Indiana customer's site. The larger furnaces were assembled at the Ohio facility, disassembled, and shipped to the Indiana site; alternatively, the larger furnaces were only partially assembled at the Ohio facility before being "knocked down," transported and reassembled at the Indiana customer's site. In all cases, the court found that the "parties contemplated and intended that the furnace . . . should be shipped and transported from appellee's plant at Toledo, Ohio to the customer's plant in Indiana . . . ." Id. 53.

In Surface Combustion, it was the Indiana customer's responsibility to provide a foundation, plumbing, and electric wiring in preparation for the installation of the furnaces. Id. It was appellee taxpayer's own responsibility to provide the "specially trained factory engineers, supervisors, and workmen to assemble . . . install, align, and adjust all of [the furnaces] at the customer's plant in order to assure a proper functioning furnace which was necessary to consummate and complete the sale." Id.

The court rejected the Department's contention that it was entitled to levy the Gross Income Tax against appellee taxpayer's income derived from the sale of the furnaces. The court found that, "the tax sought to be recovered was levied upon the gross receipts of appellee from interstate commerce transactions within and without the State of Indiana." Id. at 69. The court concluded that imposition of the tax "directly burdens, and interferes with, the free flow of such commerce between the State of Ohio and the State of Indiana and is invalid as being in conflict with Article I, of § 8 of the Constitution of the United States." Id.

The court found that the "thing" which the Indiana customer purchased from appellee in Ohio, was a "heat treating furnace complete in one functional unit." Id. at 62. In support of that conclusion, the court noted that, "There is no evidence that the furnaces were made, built, fabricated, created or brought into existence in Indiana." Id. The Indiana installation work performed by appellee taxpayer consisted "only in the reassembling and installing the furnaces which had been purchased in the State of Ohio and taken apart for the convenience of shipment." Id. Appellee taxpayer's in-state activity was "intrinsically related to and inherently a part of the sale; and because of their complexity their installation and testing was essential to the making of the sale." Id. The sales of the furnaces were "clearly sales of personal chattels in interstate commerce and the installation and reassembling where required, were inherently a part of, and a necessary incident to, the sale." Id.

Taxpayer also cites to Indiana Dept. of Revenue v. Brown Boveri Corp., 439 N.E.2d 561 (Ind. 1982) in support of the proposition that sales of its steel-making equipment is not subject to the Gross Income Tax. In Brown Boveri, plaintiff taxpayer was an out-of-state company which had entered into a contract with an Indiana manufacturer for the sale of an induction melting system. The parties' sales agreement was for the "turn-key" delivery of a system that would produce molten iron. "The system was pre-fabricated at [plaintiff taxpayer's] plant, broken down for shipment and reassembled at the [Indiana customer's] plant." Id. at 563. Plaintiff taxpayer conducted certain activities at the Indiana site because it "was necessary for [plaintiff taxpayer] to engage in various activities to guarantee proper planning and coordination of the project." Id. Plaintiff taxpayer's in-state activities "included reassembly of the equipment, removing obsolete equipment, pouring foundations, trenching, and reinforcement of existing structures." Id.

The court disagreed with the Department's argument that plaintiff taxpayer's performance of activities within Indiana removed the transaction from the protection afforded interstate commerce. Id. at 564. The court found that the transaction between plaintiff taxpayer and the Indiana customer was "indeed interstate commerce such that taxation of gross income resulting therefrom [was] prohibited." Id. The transaction was for the "sale of a functioning system for a lump sum," in which "all of the component parts were pre-fabricated outside Indiana, disassembled for shipment, and then reassembled on the job site." Id. Plaintiff taxpayer's local activities did not take the sale of the melting system outside interstate commerce protection because "the local activities of [plaintiff taxpayer] were intrinsically related to and inherently part of the sale in interstate commerce." Id.

In both Brown Boveri and Surface Combustion, the out-of-state taxpayer constructed equipment and then shipped that equipment – either piece-meal or as a complete unit – to the Indiana customer. The court found, in both instances, that the sale of the equipment was interstate in character while taxpayers' in-state activities – installing and testing the equipment – were inherently related to the original out-of-state sale.

Taxpayer entered into numerous subsidiary transactions most of which are entirely irrelevant to the taxpayer's protest. Pursuant to those subsidiary transactions, taxpayer hired subcontractors to construct individual component parts. In some cases, taxpayer was closely involved in the actual fabrication of these components. Taxpayer – in some instances, together with the Indiana customer – closely monitored the components' construction in order to assure that components conformed to design standards and in order to assure that the components were completed in a timely fashion. At some point, taxpayer took possession of the components and shipped them to the Indiana destination by means of common carrier. Because of their size, some of the components were partially disassembled before shipment.

None of these numerous subsidiary transactions are relevant to taxpayer's protest because taxpayer is not engaged in the business of selling unassembled components to the Indiana customers. It is the sales of the finished steel-making machines to the Indiana customers which underlie the taxpayer's protest.

Taxpayer's sale of its steel-making machines is not identical to the transactions described in Brown Boveri and Surface Combustion. In Surface Combustion, the court stated that there was "no evidence that the furnaces were made, built, fabricated, created, or brought into existence in Indiana." Surface Combustion, 111 N.E.2d at 62. While the numerous individual components may have existed outside of Indiana, there is every indication that the steel-making machines themselves were "made, built, created, [and] brought into existence in Indiana." Brown Boveri, 439 N.E.2d at 563. In Brown Boveri, the court found that, "The system was pre-fabricated at [taxpayer's] plant, broken down for shipment and reassembled at the [Indiana] plant." Id. The taxpayer's own steel-making machines were not pre-fabricated outside the state, broken down for shipment, and reassembled at the Indiana customers' steel plant. Instead, the steel-making machines were not brought into existence until taxpayer transported the components to the site and then assembled those components into the steel-making device which taxpayer sold to the Indiana customers. Taxpayer's sales of steel-making machines were not interstate transactions with the taxpayer's performance of Indiana installation activities merely incidental to the sale of the steel-making machines. Instead, taxpayer's initial construction and sale of the steel-making machines occurred in Indiana and the proceeds are properly subject to the state's Gross Income Tax.

Taxpayer's sales of the steel-making equipment is analogous to the activities of appellee manufacturer in Gross Income Tax Division, State of Indiana v. Fort Pitt Bridge Works, 86 N.E.2d 685 (Ind. 1949). In that case, the manufacturer – a Pennsylvania based corporation – arranged for the construction, fabrication, and assembly of certain buildings within the state. The manufacturer "furnished and fabricated the steel and shipped it from its plants in Ohio or Pennsylvania" to the customer's location within Indiana. Id. at 687. Thereafter, a subcontractor received the material and performed all the work necessary for the "construction of the buildings for which the steel was furnished." Id. The manufacturer treated the receipts as not subject to Indiana's Gross Income Tax because, according to the manufacturer, "it had nothing to do with the activity and business conducted in Indiana by [the subcontractor] and that it [was] not liable for tax upon the price paid for the steel and fabrication . . . because the fabrication occurred outside the state and furnishing the steel was an interstate transaction." Id. at 688. The court disagreed with the manufacturer's contention on the ground that, "A corporation which contracts in the state of its residence to do work in a foreign state subjects itself to the jurisdiction of such foreign state, notwithstanding it employs independent contractors to do the actual work and does no part of the actual work itself." Id. at 689. The manufacturer's income was subject to Indiana's Gross Income Tax because "it was derived from an activity for which it was responsible. It came from its business in Indiana, carried on through the medium of a subcontractor acting independently as to the manner and method, but acting for [the manufacturer] in the accomplishment of the result which it contracted to bring about." Id.

The court rejected the manufacturer's argument that the transaction was interstate in nature because the court did not believe the contract "was a contract of sale with construction work in Indiana as a mere incident." Id. at 691. Even though the component parts were initially manufactured at an out-of-state location, "the transaction as a whole was local in nature and subject to local tax and regulation." Id. The court stated that it had "no hesitance in saying that the State of Indiana [had] the right to apply its gross income tax to business actually transacted within its borders, notwithstanding that interstate commerce, as an incident, may have intervened in at some point in the transaction . . . ." Id. at 692.

The taxpayer's own acquisition of components from its hundreds of suppliers was merely incidental to the assembly and sale of the steel-making machines to its Indiana customers. The proceeds from sales of the steel-making machines are subject to the state's Gross Income Tax because the sales transactions were local and nature and not inherently part of interstate commerce. There is no indication Indiana's imposition of Gross Income Tax discriminates against interstate commerce or imposes a multiple taxation burden on taxpayer.

The taxpayer's 1995 through 1998 transactions fall within the purview of the state's Gross Income Tax scheme as set out in 45 IAC 1-1-121(b) which states that:

> Gross receipts from the performance of construction projects in Indiana are subject to gross income tax. This is true even when the contractor is a nonresident and even when he subcontracts all Indiana work to local businesses and has no other contact with the state except to ship goods manufactured elsewhere into the state for installation by local workmen.

Taxpayer's Indiana activities are not merely "incidental services taking place within the State, which may be tax-exempt as a transaction in interstate commerce." 45 IAC 1-1-121(d). Taxpayer is not merely setting the equipment "on bases or connecting to pipes, supports, etc., provided by the customer." Id. Rather, taxpayer clearly "performs additional services, such as installation, testing, construction, etc." entitling the Department to treat the transaction as a "construction project" the proceeds of which are properly subject to the state's Gross Income Tax. Id. *See also* 45 IAC 1.1-3-3(d).

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence and Underpayment Penalties.

At the conclusion of the audit review, taxpayer was assessed a ten-percent negligence penalty. According to taxpayer, the Department assessed an "underpayment penalty" for the 1999 tax year pursuant to IC 6-8.1-10-2.1.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer filed no Indiana tax returns for 1995, 1996, 1997, 1998, and 1999 on the ground that had no tax liability for those years. While the sales of the steel-making equipment arguably implicated transactions involved in interstate commerce, taxpayer received substantial income from the provision of related services within the state. Its determination that it had zero tax liability during the five years falls outside a reasonable definition of "ordinary business care and prudence" and does not warrant abatement of the associated penalties.

FINDING

Taxpayer's protest is respectfully denied.

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